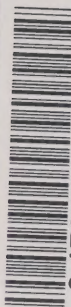


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Report on the

REVIEW

of the 2003-04 Fiscal Outlook

Prepared for the Premier of Ontario
by Erik Peters, FCA
October 29, 2003

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To the Honourable Dalton McGuinty,
Premier of Ontario

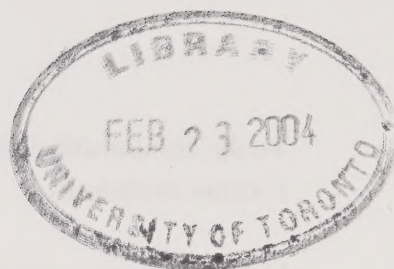
I have the honour of presenting to you this report on the review of the 2003-04 fiscal outlook for the Province of Ontario, carried out in accordance with the agreed-upon Terms of Reference.

I would like to acknowledge the co-operation and assistance of the staff of the Ministry of Finance who provided invaluable help in carrying out the review.

Respectfully submitted,

Original signed by
Erik Peters, FCA

Toronto, 2003



Scope and Objectives

As agreed, I have carried out a review, which does not constitute an audit, of a comparison between the Budget for 2003-04, released on March 27, 2003, and the fiscal update for 2003-04 prepared by the Ministry of Finance as of October 24, 2003.

The March 27, 2003 Budget for 2003-04 was presented by the government of the day. The October 24, 2003 update for the same fiscal year is the responsibility of the Ministry of Finance and has been prepared by the Ministry based on its assumptions about future events and the consensus economic outlook in October 2003. The October update reflects the taxation and other fiscal policies underlying the March 2003 Budget.

Owing to the future-oriented nature of the assumptions and resulting information, neither the assumptions nor the information can be audited. This is why my review does not constitute an audit. The review involved enquiring about the information the Ministry provided, examining the support that the Ministry provided for its assumptions and assessing the computations the Ministry used to translate its assumptions into the October 24 update.

Conclusion

Since the 2003-04 fiscal outlook updated as of October 24, 2003, and the projected deficit contained in that outlook are based on assumptions regarding future events, actual results will vary from the information presented and the variations may be material. In this regard, Table VI lists a number of additional risks not included in the projected deficit amount, while Table VII lists uncertainties with positive potential. Also, government decisions after the date of this review (for example, whether to set aside funds against contingencies for the rest of the year, as noted under Observations) will have an impact on the projected deficit. I consider the projected deficit, before the impact of risks and uncertainties, future government decisions and unforeseen events, of \$5.6 billion to be based on assumptions that are reasonable at this time. For the reasons I have outlined above, I express no opinion as to what the actual deficit for the year ending March 31, 2004 will be.

Fiscal Accountability and Transparency

In light of the significant differences between the March 2003 Budget, the June 30 *Ontario Finances* update and the current fiscal outlook, I urge the new government to consider legislation dealing with fiscal responsibility. The objective would be to improve accountability through greater transparency in and quality of budgets and updates such as the quarterly *Ontario Finances*. This approach would be more effective in ensuring fiscal accountability than legislation that limits government's flexibility in responding to fiscal challenges.

Summary Information

The information provided by the Ministry may be summarized as follows:

Table I. Unaudited summary of changes to 2003-04 fiscal outlook since March 2003 Budget

	\$ billions		
	2003 Budget	Current outlook	Impact on deficit
Revenue outlook (see Table II, below)	71.6	67.2	4.4
Expenditure outlook (see Table III, below)	70.6	72.1	1.5
Increase in stranded debt	0.0	0.7	0.7
Budgetary reserve	1.0	0.0	(1.0)
Projected deficit for 2003-04	0.0	5.6	5.6

Table II. Downward revisions in revenue outlook

	\$ millions
Impact of slower-than-budgeted economic growth on tax revenue	1,290
Revised assumptions regarding federal Canada Health and Social Transfer (CHST) payments	273
Lower-than-budgeted income from Crown corporations	961
Other revenue shortfalls, mainly asset sales target not met	1,862
Total projected revenue shortfall compared to March Budget	4,386

Table III. Upward revisions in expenditure outlook

	\$ millions
Unspecified savings targets from Program Review and Evaluation not met	500
Year-end savings not identified or found	300
SARS-related expenditures of \$720 million, net of expected recoveries of \$250 million from the federal government	470
Various in-year approvals and other expenses not provided for in the March 2003 Budget	1,038
Drawdown of contingency fund, completely allocated	(762)
Total projected expenditure increase compared to March Budget	1,546

Observations

My observations are made without the benefit of the Public Accounts for the year ending March 31, 2003, which had not been tabled at the time of this review. As well, up-to-date unaudited financial performance information beyond June 30, 2003 was not available.

My observations fall into the following areas:

- the impact of changes in assumptions used to update the fiscal outlook;
- the increase in stranded debt from the electricity sector;
- the impact of initiatives included in the March 2003 Budget that have not been acted upon;
- other risks and uncertainties that are not included in the deficit number; and
- setting up a contingency fund and a budgetary reserve for the remainder of the fiscal year.

Changed assumptions

The following table summarizes changes in assumptions used in developing the fiscal outlook that had a significant impact.

Table IV. Changes in assumptions with significant downward impact on revenues

	Projected impact, \$ millions
<u>Taxation revenues:</u>	
Slower growth in real GDP (see Note 1, below)	695
Changed composition of real GDP growth (see Note 2, below)	265
Lower-than-expected 2002 Personal Income Tax assessments	200
Retail Sales Tax holiday for accommodations and admissions, to counteract impact of SARS on tourism and entertainment industries	130
<u>Other revenues:</u>	
Revised assumptions regarding CHST payments (see Note 3, below)	273
Lower-than-expected income from Crown corporations (see Note 4, below)	961
Total	2,524

Notes:

1. The current private-sector consensus forecast for Ontario's real growth in Gross Domestic Product (GDP) is 1.8 per cent, which is down by 1.2 percentage points from the 3.0 per cent growth assumption used in the March 2003 Budget. This is projected to result in a drop of \$695 million in tax revenues for the 2003-04 fiscal year, according to Ministry of Finance calculations. Ontario's economy has weakened as a result of a number of events, including SARS and the rapid appreciation of the Canadian dollar.
2. In addition, changes in the way GDP has grown will have a further impact on specific components of revenue. For example, the forecast for growth in wages and salaries, the key driver of Personal Income Tax and Employer Health Tax, has fallen from 6.0 to 3.6 per cent since the March 2003 Budget.

3. The revised assumptions regarding federal CHST payments comprised two components:

- a) Eliminating the 2003-04 CHST top-up results in a \$771 million increase in the projected deficit.

The March 2003 Budget assumed that in January 2004 Ontario would receive a new CHST supplement of \$771 million from the federal government. In the updated 2003-04 fiscal outlook, this amount has been deleted, as it is subject to confirmation by the federal government. That confirmation depends upon the federal government recording a specified surplus for the 2003-04 fiscal year.

In addition, the terms of this CHST supplement would have to vary significantly from previous such supplements for the Province to record it as revenue for 2003-04. Ontario recorded previous supplements, in accordance with the underlying trust agreements, as revenues over three years, beginning in the year after they were provided by the federal government.

Therefore, considerable uncertainty surrounds the supplement. First, the federal government may not provide it at all. Second, the terms on which it is given will determine whether it can be recorded as revenue in 2003-04. If both of these uncertainties were to be overcome, there would be a deficit reduction of up to \$771 million.

- b) Recording a portion of the 2002-03 CHST supplement as revenue in 2003-04, consistent with Ontario's accounting treatment of previous CHST supplements, and other changes, results in a \$498 million reduction in the projected deficit.

4. The income from Crown corporations is expected to be lower by \$961 million from that forecast in the March 2003 Budget, because of:

- a) The projected decrease in the income of the Ontario Lottery and Gaming Corporation (\$308 million) and of the Liquor Control Board of Ontario (\$75 million) owing to SARS, the Iraq war and other events that reduced the number of visitors to Canada;
- b) The estimated reduction in the income of Ontario Power Generation Inc. (\$555 million), owing mainly to start-up costs of the Pickering A nuclear facility; and Hydro One Inc. (\$23 million), owing mainly to the August 2003 power outage. This reduces the forecast income from the two Crown corporations from \$884 million to \$306 million, which in turn

accounts for part of the increase in the stranded debt of the electricity sector.

Several factors, including the significant drop in the income of Ontario Power Generation Inc. (OPG), its low rate of return on equity, the ongoing problems and escalating costs of restarting the Pickering nuclear facility, and deferment of repayments of debt to the Province, clearly indicate the need to better deal with the Province's investment in OPG. This is an urgent matter, since OPG appears to depend more and more on financial support from the Province.

Increase in stranded debt of the electricity sector

The March 2003 Budget did not provide for any increase in stranded debt related to the electricity sector. The downward revision in the projected income of Ontario Power Generation Inc. and Hydro One Inc. results in an increase of \$364 million in stranded debt. The other component of the increase in stranded debt, amounting to \$293 million, is attributable to the net impact of the 4.3-cent cap on the retail price of electricity legislated in December 2002 for certain classes of consumers.

These factors, and other changes that have a net impact of \$46 million, result in a projected increase in stranded debt and consequently in the projected deficit of \$703 million. This and previous increases in stranded debt indicate that it is no longer appropriate to exclude the stranded debt of the electricity sector from the provincial debt.

Budget initiatives not acted upon

The March 2003 Budget included initiatives for which no detail was provided, as follows:

- Other revenues, primarily gain on sale of unspecified assets: \$1,862 million
 - Although the March 2003 Budget provided for a gain on asset sales and rentals of \$2,207 million, there has been only one major sale to date, that of the Government's share of Teranet, at an estimated gain of \$132 million.

- The Ministry of Finance has no information specifying which other assets were to be sold. Accordingly, the forecast revenue has been reduced to \$439 million. In addition to the Teranet gain, the \$439 million number represents other miscellaneous sales and rentals of \$307 million, which is in line with normal results in previous years. The new government will have to assess the feasibility of attempting to reduce the projected deficit for 2003-04 by selling Crown assets.
- There have also been a number of additional reductions in expected other revenues, totalling \$94 million, which are not related to asset sales and rentals.
- The net impact of these reductions is an increase of \$1,862 million in the projected deficit, summarized as follows:

Table V. Other revenue shortfalls

	\$ millions		
	2003 Budget	Current outlook	Change
Sales and rentals of government assets	2,207	439*	(1,768)
Other (fees, licences and other non-tax revenues)	4,011	3,917	(94)
Total	6,218	4,356	(1,862)

* Includes the gain on sale of Teranet of \$132 million.

■ Unspecified savings targets: \$800 million

- The March 2003 Budget included unspecified savings of \$500 million from “Program Review and Evaluation” and \$300 million from a “Year-End Savings Target,” without identifying these savings.
- To date, no action has been taken on these targets and therefore the projected deficit has been increased by \$800 million. The new government will have to assess the feasibility of pursuing these targets in whole or part to provide relief (see Table VII).

Identified risks and uncertainties

The following table outlines risks that have been identified but are not reflected in the projected deficit, and may require funding decisions:

Table VI. Identified risks

	\$ millions
Residual system-wide hospital deficits	Up to 350
Other health-care expenditures	Up to 150
Justice sector funding pressures	Up to 150
Education sector funding pressures	Up to 65
Costs above Independent Electricity Market Operator uplift charge	Up to 150
Financial help to public entities for power outage	Up to 75
Impact of further strengthening of the Canadian dollar on revenues	Unspecified

The following table lists other uncertainties that are not included in the projected deficit and may, at least in part, provide relief.

Table VII. Uncertainties with positive potential

	Potential relief, \$ millions
2003-04 CHST supplement (see Note 3a to Table IV)	Up to 771
Growth in real GDP of more than 1.8 per cent	Up to 200
Year-end savings, including hiring freeze	Up to 200

Contingency fund and budgetary reserve

The March 2003 Budget included a contingency fund of \$762 million and, in line with the recommendations of the Ontario Financial Review Commission, a budgetary reserve of \$1.0 billion against unforeseen events that might put the fiscal plan at risk.

By the time of the update to the fiscal outlook in October 2003, the contingency fund had been allocated to unexpected costs and the Ministry of Finance had deemed the budgetary reserve to have been used up. However, the fiscal year is not over and there is some likelihood of additional costs or revenue shortfalls not included in the updated fiscal outlook. For this reason, the government may wish to establish a reserve and/or contingency fund to cover the remainder of 2003-04.

